

**Law Society's Comments on the Administration's  
Explanatory Paper on the Operation of the Proposed Section 7AI**

1. With respect to whether there should be a claw back provision at all in the legislation, the Law Society's views are set out in its submission dated 1 February 2011. This submission supplements our views on the actual operation of section 7AI as currently drafted and the proposed 6 year limitation period.
2. Paragraph 12 of the Administration's explanatory paper on the operation of the proposed section 7AI in February 2011 ("Explanatory Paper") summarised the three factors that need to be considered when ascertaining whether a distribution is liable to be clawed back. They include:
  - (a) whether as a consequence of the distribution, the LLP has failed the liquidity test or the asset test;
  - (b) whether the LLP owes an obligation to the claimant at the time of the distribution;
  - (c) whether the distribution is made more than 6 years before the commencement of the clawback action, if 6 years is to be adopted as the limitation period.
3. The three factors set out in the Explanatory Paper look simple and straight forward on the surface. However, when one works on those factors to determine if a distribution is liable to claw back, problems emerge. Further, the DOJ's Example is simplistic and potentially misleading as it suggests that law firms routinely fail to satisfy one of the financial tests. On the contrary, most law firms will satisfy both the liquidity and asset tests unless and until some unusual liability occurs, such as a large negligence claim

**Knowledge of negligence at the time of distribution**

4. In paragraph 9 of the Explanatory Paper, the Department of Justice ("DOJ") asserts that distribution D2(2) is liable to be clawed back, even though the client has not informed the law firm of the negligence claim at that time. The argument in this paragraph is unclear, but it appears that the DOJ is asserting that any distribution occurring after the date of the negligence by the law firm is subject to the clawback if the law firm failed one of the financial tests at the time of the distribution. This contradicts the purpose of the claw back provision.
5. If the law firm has not been informed of the claim by the client (and if the law firm does not otherwise know of the negligence), then the law firm has no way of knowing that a contingent partnership obligation to that client exists. Thus, the law firm cannot ever take that claim into account in determining the proper amount of the distribution so as to satisfy the asset test. At the least, this problem underscores the need to value contingent obligations on some fair value basis (where obligations that one does not know about are valued at zero). Until the law firm is put on notice of a claim, it should not be the case that a distribution could be subject to clawback because of that claim.

6. Under the DOJ's analysis, a distribution could be subject to a clawback even if no one (neither the client nor the law firm) knew of the potential claim at the time of the distribution. Considering that the Administration's motivation for including the clawback was to prevent asset stripping, this result makes no sense.
7. An alternative interpretation to address this problem is to conclude that there is no contingent partnership obligation in respect of the negligence claim until and unless the client has made a claim of some type (informal or formal) against the law firm. The DOJ, explicitly and implicitly (e.g., in paragraph 12(b)) asserts that the partnership obligation arises at the time of the negligence (regardless of whether the parties are aware of the negligence), which is not practical.
8. For similar reasons, the reference in paragraph 10 of the Explanatory Paper to 1 January 2010 is incorrect; at the earliest, it should be 1 January 2011, the date on which the client notified the law firm of the claim.

#### **Practical difficulty in calculating clawback before judgment**

9. Section 7AI allows any person to whom the partnership owes any partnership obligation at the time of distribution to take out proceedings to enforce a partner's liability to return that distribution to the partnership if the value of the partnership property is less than that of the partnership obligations.
10. Section 7AI(4) specifically provides that "partnership obligations" cover actual and contingent obligations.
11. Accordingly, section 7AI will effectively allow a claimant to commence proceedings to enforce a partner's liability to return a distribution to the partnership even before the claimant has obtained judgment on his negligence claim as long as the partnership property is less than the partnership obligations taking into account his claim (which is a contingent partnership obligation).
12. The issue is before judgment has been obtained for the claim, how much of the claim should be allowed for the purpose of determining if the value of partnership obligation is more than that of partnership property. It poses problems for the following reasons:
  - (a) the amount of the claim at this point will reflect merely the plaintiff's assertion as to what the plaintiff is owed, and the claim may be completely invalid or far larger than the amount (if any) that is ultimately determined to be payable to the plaintiff;
  - (b) an assessment of quantum at the early stage of the claim proceedings is extremely difficult.
13. Using the same Example in the Explanatory Paper, assuming that
  - (a) the claim is for \$20 million,
  - (b) the LLP considers the claim excessive;

- (c) after seeking Counsel's advice, the LLP considers a provision for \$2 million for the claim appropriate;
  - (d) if the firm intends to make a distribution to its partners, it is unclear as to which amount of the claim (the full \$20 million or \$2 million based on Counsel's advice) it should adopt as the value of the obligation in relation to the claim when it carries out the asset test for the purposes of section 7AI. (before taking into account any professional indemnity insurance cover).
14. Further, a claimant is entitled to initiate a claw back action as soon as the LLP owes him an obligation, albeit a contingent obligation. Accordingly, the claw back action may be commenced at the early stage of the negligence claim proceedings during which an assessment of quantum is very difficult. Without a fair estimate of the quantum of the claim at the time of the distribution, there is no valid basis to determine the value of the LLP's obligations for the purposes of section 7AI.
  15. Consequently, the existing section 7AI lacks certainty and is practically unworkable.
  16. To address this defect, some objective bases to determine whether a distribution should be made must be included in the legislation.

#### **Reasonable and fair basis for distribution**

17. If a comparison is made with the few Canadian jurisdictions that have provisions regulating distribution of partnership property in LLPs, it is noted that they do expressly provide for the bases to determine whether a distribution should have been made, namely,

*“(a) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances;*

*(b) on a fair valuation;*

*(c) on another method that is reasonable in the circumstances.”<sup>1</sup>*

18. The inclusion of a similar provision will add certainty and predictability to the provision so that at the very least, an LLP will know how to ensure compliance with it, particularly after taking into account the statutory professional indemnity insurance cover (currently up to a maximum of HK\$10 million per claim) and any other top-up insurance cover (if applicable).

#### **Competing Unsecured Creditors**

19. Further, the Law society doubts the usefulness of the clawback action to the claimant. Assuming that a claimant has obtained a clawback order before judgment and partners are ordered to return the distributions they received to the partnership, the claimant is still simply an unsecured creditor with no assurance that he will be entitled to the distributions returned to satisfy any judgment that he can subsequently obtain on his

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<sup>1</sup> Based on section 85(5) Manitoba Partnership Act and Section 83(5) Saskatchewan Partnership Act  
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negligence claim, as there may be other competing unsecured creditors against the partner (s) involved.

**Impact on bankruptcy law**

20. In the event of bankruptcy of the partner (s) involved, all unsecured creditors will rank pari passu for distribution of the bankrupt's estate under the existing bankruptcy law. Sections 50, 51 and 51B of the Bankruptcy Ordinance provides, in effect, for clawback of partnership distribution up to 2 years before the date of presentation of the bankruptcy petition.
21. As such, the 6 years' limitation period for clawback by a claimant as proposed by the Administration may have the unintended consequence of altering the existing bankruptcy law and cause prejudice to other unsecured creditors.
22. Hence, the Law Society does not support the Administration's proposal for the 6 years' limitation period for clawback by a claimant.

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